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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION OF  
BELLA VISTA WATER CO., INC. AN  
ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANTS AND PROPERTY AND  
FOR INCREASES IN ITS WATER RATES  
AND CHARGES FOR UTILITY SERVICE  
BASED THEREON.

DOCKET NO. W-02465A-09-0411

IN THE MATTER OF THE APPLICATION OF  
NORTHERN SUNRISE WATER COMPANY,  
INC., AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANT AND PROPERTY AND  
FOR INCREASES IN ITS WATER RATES  
AND CHARGES FOR UTILITY SERVICE  
BASED THEREON.

DOCKET NO. W-20453A-09-0412

IN THE MATTER OF THE APPLICATION OF  
SOUTHERN SUNRISE WATER COMPANY,  
INC., AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANTS AND PROPERTY AND  
FOR INCREASES IN ITS WATER RATES  
AND CHARGES FOR UTILITY SERVICE  
BASED THEREON.

DOCKET NO. W-20454A-09-0413

IN THE MATTER OF THE JOINT  
APPLICATION OF BELLA VISTA WATER  
CO., INC., NORTHERN SUNRISE WATER  
COMPANY, INC., AND SOUTHERN  
SUNRISE WATER COMPANY, INC. FOR  
APPROVAL OF AUTHORITY TO  
CONSOLIDATE OPERATIONS, AND FOR  
THE TRANSFER OF UTILITY ASSETS TO  
BELLA VISTA WATER CO., INC.,  
PURSUANT TO ARIZONA REVISED  
STATUTES 40-285.

DOCKET NO. W-02465A-09-0414  
DOCKET NO. W-20453A-09-0414  
DOCKET NO. W-20454A-09-0414

STAFF'S REPLY BRIEF

1 **I. INTRODUCTION.**

2 The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") has  
3 already responded in its Post-hearing brief to many of the arguments made by Bella Vista Water  
4 Company, Northern Sunrise Water Company, and Southern Sunrise Water Company (collectively  
5 "the Company") and responds as follows to the closing briefs filed by the Company and the  
6 Residential Utility Consumer Office ("RUCO"). The purpose of this Reply Brief is not to repeat  
7 every point made in Staff's Initial Closing Brief, nor will it attempt to refute every single issue raised  
8 by the Company or RUCO; instead Staff relies upon its testimony on those issues not specifically  
9 addressed in this Reply Brief. The recommendations of Staff and its positions have been outlined in  
10 its Opening Brief as well as its testimony. Staff will highlight some of the major points of  
11 disagreement with the Company in this brief.

12 **II. THE LEGAL FRAMEWORK FOR RATEMAKING.**

13 **A. In Exercising Its Broad Discretion Under the Arizona Constitution, the**  
14 **Commission Sets Rates That Are Just and Reasonable, Balancing the Interest of**  
**Utilities and Those of the Ratepayers.**

15 As the Company has stated, a utility is entitled to rates that provide sufficient revenue to allow  
16 recovery of reasonable operating expenses and a fair rate of return. It is the Commission's  
17 responsibility in ratemaking to set rates which allow sufficient revenue. However, the Company  
18 appears to argue that the Commission is limited in the factors it can consider when setting just and  
19 reasonable rates. Staff would caution against a narrow interpretation of the Commission's plenary  
20 rate making authority.

21 Article 15, section 3, of the Arizona Constitution provides, in relevant part, that the  
22 Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be  
23 used and just and reasonable rates and charges to be made and collected, by public service  
24 corporations within the State for service rendered therein . . . ." In determining just and reasonable  
25 rates, the Commission has broad discretion, subject to the obligation to ascertain the fair value of the  
26 utility's property and to establish rates that "meet the overall operating costs of the utility and  
27 produce a reasonable rate of return."<sup>1</sup> Under the Arizona Constitution, a utility company is entitled to  
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<sup>1</sup> *Scates v. Ariz. COT. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 615 (App. 1978).

1 a fair rate of return on the fair value of its properties, "no more and no less."<sup>2</sup> Arizona law does not  
2 mandate that the Commission (1) follow a particular method in its rate making determinations or (2)  
3 exclude consideration of relevant factors.<sup>3</sup>

4 The Commission may consider all of the available evidence and may use its expertise to  
5 reconcile the evidence and develop a reasonable resolution. The ratemaking process does not lend  
6 itself to rule formulation because relevant factors may be given different weight at the discretion of  
7 the Commission at the time of inquiry. The court held in *Bluefield*:

8  
9 What annual rate will constitute just compensation depends upon many  
10 circumstances and must be determined by the exercise of fair and enlightened  
11 judgment, having regard to all relevant facts. . . A rate of return may be  
12 reasonable at one time and become too high or too low by changes affecting  
opportunities for investment, the money market and business conditions  
generally.<sup>4</sup>

13 The Company seemingly understates the responsibilities of the Commission in the setting of  
14 rates. Protecting ratepayers, however, is part of the balancing in the public interest performed by the  
15 Commission. The Commission not only sets just and reasonable rates for public service corporations,  
16 but also sets rates to protect ratepayers from overreaching by those very corporations.<sup>5</sup> The  
17 Company's arguments are no more than an attempt to undermine the Commission's responsibility of  
18 balancing the customer and utility interests at the expense of ratepayers. "The jurisprudence of our  
19 State made it plain long ago that the interests of the public-service corporation stockholders must not  
20 be permitted to overshadow those of the public served."<sup>6</sup>

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22  
23 <sup>2</sup> *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 451, 874 P.2d 988, 991 (App. 1994)  
24 (citing *Ariz. Corp. Comm'n v. Citizens Util. Co.*, 120 Ariz. 184, 431, 584 P.2d 1175, 1181 n.5  
(App. 1978)).

25 <sup>3</sup> *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

26 <sup>4</sup> *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692 (1923).

27 <sup>5</sup> *Scates*, 118 Ariz. at 534, 578 P.2d at 615.

28 <sup>6</sup> *Ariz. Cmty. Action Ass'n v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 231, 559 P.2d 184, 187 (1979);  
*Ariz. Corp. Comm'n v. Woods*, 171 Ariz. 286, 296, 830 P.2d 807, 817 (1992) ("The Commission  
was not designed to protect public service corporations and their management, but rather, was  
established to protect our citizens from the results of speculation, mismanagement and the abuse of  
power.")

1 **III. RATE BASE.**

2 **A. Plant Not Adequately Supported Or Documented Should Be Removed From**  
3 **Rate Base.**

4 In the Company's Initial Closing Brief, the Company agrees with Staff that it is the  
5 Company's responsibility to support its claimed costs.<sup>7</sup> However, the Company goes on to claim that  
6 "Staff *admitted* that the Company's books and records *support* the plant costs at issue."<sup>8</sup> However,  
7 that mischaracterizes Ms. Brown's testimony during the hearing; Ms. Brown was asked whether she  
8 agreed if the plant costs (the costs which Ms. Brown had adjusted), were reflected as entries in the  
9 Company's books and records;<sup>9</sup> Ms. Brown agreed they were. However, as the Company would have  
10 you believe, stating that a cost is written in a Company's ledger is not admitting that there is adequate  
11 support for that cost.

12 This gets to the heart of the issue. The Company was able to provide invoices supporting over  
13 94% of the costs recorded in its books, but was unable to provide documentation for the remaining  
14 items. Staff believes it is prudent and reasonable to require the Company to provide adequate  
15 documentation beyond a number written by a Company employee in a book or ledger, to substantiate  
16 the cost of the plant. When a Company can provide over 94% of the invoices as documentation, why  
17 can it not provide the other 6%? Absent adequate verification of claimed costs, Staff believes the  
18 ratepayers are in jeopardy of over-paying and potentially even paying for non-existent plant.<sup>10</sup>  
19 Additionally, the Commission has in the past adopted Staff's recommendation to disallow plant  
20 where the utility lacked adequate documentation.<sup>11</sup>

21 **B. Customer Security Deposits Are Appropriate Reduction To Rate Base.**

22 Customer security deposits represent funds received by ratepayers for security in the event of  
23 nonpayment of their bill to the Company.<sup>12</sup> These types of funds are similar in nature to customer  
24 advances for construction. Like customer advances, the deposits are available to the utility for use in  
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26 <sup>7</sup> Company's Initial Closing Brief at 49:5.

27 <sup>8</sup> *Id.* at 46.

28 <sup>9</sup> Tr. at 881:16-21.

<sup>10</sup> Ex. S-6 at 13-14 (Direct Testimony of Crystal Brown).

<sup>11</sup> See Decision. Nos 70627 and 70170.

<sup>12</sup> Tr. at 956.

1 support of its rate base investment. As a result, Staff includes customer security deposits as a  
2 reduction to rate base. Staff made this adjustment in the Litchfield Park Service Company Case, and  
3 it was adopted by the Judge in her Recommended Opinion and Order ("ROO").<sup>13</sup>

4 Staff's position is also supported by the *Rate Case and Audit Manual*, prepared by NARUC  
5 Staff Subcommittee on Accounting and Finance (2003):

6 Customer deposits are shown as a liability on the utility's balance sheet and  
7 represent a source of non-investor supplied capital. Customer deposits are  
8 generally treated one of three ways.

9 The first method does not reduce rate base by the customer deposits balance  
10 and classifies any interest accrued or paid on those deposits as a below-the-line  
11 (or non-operating) expense. This method allows the utility to earn a return on a  
12 rate base that has not been reduced by the amount of customer deposits, and  
13 then allows it to use that return to pay the interest that is required to be  
14 returned to customers with the return of that deposit. One consideration in  
15 using this method is whether the return allowed on rate base is higher than the  
16 return that the utility is required to pay on its customer deposits. If so, the  
17 utility may be allowed to earn more than is necessary, and return that  
18 difference to shareholders.

19 The second method reduces rate base by the customer deposits balance, and  
20 classifies any interest accrued or paid on those deposits as an above-the-line  
21 (or operating) expense that is included in the revenue requirement  
22 computation. The interest that the utility must pay is generally deemed to be a  
23 legitimate expense that must be recovered in one form or another.

24 The third method includes the liability for customer deposits in the utility's  
25 capital structure at a zero cost, reducing the overall rate of return. If interest is  
26 paid on the customers' deposits, the utility can recover that interest expenses as  
27 an above-the line (or operating) expense.<sup>14</sup>

28 Staff followed the approved methodology as recommended by the utility regulatory  
profession and their adjustment should be adopted.

29 **C. Non-Depreciable Land Should Not Be Included In The Composite Rate For The**  
30 **Accumulated Amortization Of CIAC Calculation.**

31 The parties are in agreement that CIAC should be amortized using a composite depreciation  
32 rate, and that the premise of using a composite rate to amortize CIAC is that all of the plant being  
33 amortized was in fact funded by CIAC. However, Staff believes that the plant included should only

34 <sup>13</sup> See Litchfield Park Service Company Recommended Opinion and Order, October 5, 2010.

<sup>14</sup> Ex. S-13 NARUC Rate Case and Audit Manual.

1 be *depreciable* plant, thus excluding land, where as the Company has included all plant, including  
2 non-depreciable land. The balance of the depreciation account and the accumulate amortization of  
3 CIAC should be equal. According to NARUC, "CIAC shall be amortized over a period equal to the  
4 estimated service life of the related contributed asset."<sup>15</sup> Land does not depreciate like other plant  
5 items, because its estimated service life is extremely long. Land is not part of depreciation expense. If  
6 the depreciation expense is to be balanced against the accumulated amortization of CIAC balance,  
7 both need to remove land.

8 **D. Individual Asset Depreciation Methodology.**

9 As Staff has repeated throughout this case, its main concern with the Company's calculation  
10 of accumulated depreciation stems from its historic use of the group depreciation method, where  
11 retirements were not removed from accumulated depreciation as required by NARUC USOA,<sup>16</sup>  
12 because retirements were not even made. The Company has created a retirement plan for this rate  
13 case, and Staff believes that it is appropriate; however it does not affect the issue here. The  
14 Company has a history of not recording plant retirement, and the group depreciation method does not  
15 work appropriately when plant is not appropriately retired. To avoid confusion on a going forward  
16 basis, Staff is recommending an individual asset depreciation methodology. The method utilizes  
17 straight-line depreciation as required by NARUC, but provides for two tiers of grouping, first by  
18 account, but then again by vintage year, so that an entire group will be fully depreciated at the same  
19 time, removing the concern that rate-payers will continue paying for fully depreciated plant.<sup>17</sup>

20 **E. ADIT – Corrected Number From Opening Brief.**

21 Staff would like to correct the number it listed in its Opening Brief for Accumulated Differed  
22 Income Taxes. Staff and the Company do not disagree on the ADIT methodology in this case;  
23 however, they do propose different numbers due to differing plant values. Staff recommends a  
24 consolidated ADIT of \$626,933, as expressed in Opening Brief Schedule CSB-3, line 42.

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27 \_\_\_\_\_  
28 <sup>15</sup> Ex S-7 at 36 (Surrebuttal Testimony of Crystal Brown).

<sup>16</sup> Ex S-6 at 20 (Direct Testimony of Crystal Brown).

<sup>17</sup> Tr. at 896-7.

1 **IV. EXPENSES.**

2 **A. Rate Case Expense.**

3 Staff would like to correct an expense number used in its Opening Brief concerning rate case  
4 expense. While discussing the estimated rate case costs for other companies that also filed rate cases  
5 for multiple systems, page 17 line 16 states that Global Water's estimated rate case cost was  
6 \$133,376. However, Staff's Surrebuttal Schedule CSD-18, line 27 accurately states that Global's  
7 estimated cost was \$400,000. Despite Global Water's estimated cost, Staff still believes that their  
8 recommend rate case expense of \$202,316<sup>18</sup> is more reasonable than the Company's claimed  
9 expenses.

10 **V. INCOME STATEMENT.**

11 **A. Central Office Cost Allocation.**

12 The Company spends a substantial portion of its brief defending the shared services model  
13 and the cost pool allocation. As stated earlier, Staff is not opposed to a shared services model; in fact,  
14 Staff made no adjustment for the costs that were allocated to Bella Vista, Northern Sunrise or  
15 Southern Sunrise from Liberty Water.<sup>19</sup>

16 The Commission has on numerous occasions disallowed expenses finding that it was a cost  
17 that was more of a benefit to a company's shareholders. For example, the Commission, *In the Matter*  
18 *of Southwest Gas Company*, denied recovery of 40% of the cost associated with dues for the  
19 American Gas Association, 50% of the cost associated with the management incentive plan and  
20 100% of the cost associated with the supplemental executive retirement plan.<sup>20</sup> While these programs  
21 may be "necessary for the proper conduct of its business," there are certain costs the Commission has  
22 stated should not be recovered in rates.

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28 <sup>18</sup> Ex. S-7 at 27 (Surrebuttal Test. of Crystal Brown).

<sup>19</sup> Ex S-6 (Direct Testimony of Crystal Brown).

<sup>20</sup> See Decision. No. 70665 (December 24, 2008) at 58.

1 The Company seems to imply that if the Commission does not accept all the cost allocation  
2 methodology and the APT costs, it would not be able to provide the same level of service. As public  
3 service corporations, Bella Vista, Northern Sunrise and Southern Sunrise are obligated to provide  
4 safe and reliable service, regardless of the business model employed.

5 Mr. Eichler suggested in his rejoinder testimony, and again during the hearing, that the  
6 Company would be willing to have an independent attestation by a third-party CPA or that the cost  
7 pool be allowed in this case and later could be subject to an independent attestation by a third-party  
8 CPA, in an attempt to prove that the costs in the pool are materially indirect costs.<sup>21</sup> The Company  
9 believes this is an appropriate option under the NARUC guidelines.<sup>22</sup> However, within the same  
10 NARUC guidelines that the Company drew this idea, there is also a definition for, and suggestion to,  
11 have a cost allocation manual, created in conjunction the regulatory agency.<sup>23</sup> However, outside of a  
12 document prepared specifically for this rate case, Mr. Eichler was unable to definitively affirm or  
13 deny whether there is a cost allocation manual at the APT level.<sup>24</sup> Staff believes that an independent  
14 attestation by a third-party CPA could be utilized during a rate proceeding but Staff would still need  
15 review the CPA's findings,<sup>25</sup> Staff cannot shift its duty to review and analyze a Company's costs to  
16 an outside source. However, Staff would not be averse to seeing a formalized cost allocation manual  
17 from the APT level, and would certainly be willing to work with the Company, prior to, or outside of,  
18 a rate case, on such a manual as the NARUC guidelines envisioned.

19 In its Opening Brief, the Company claims that its cost allocation methodology is virtually  
20 identical to the cost allocation models approved by Staff and the Commission for Global Water and  
21 Arizona American.<sup>26</sup> Staff does not believe the transcript sections cited by the Company support that  
22 assertion. Staff does agree that both Global Water and Arizona American have cost allocation  
23 methodologies, and that the costs claimed by those companies utilizing those methodologies have for  
24 the most part been approved by the Commission. The Company did not present this argument until  
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26 <sup>21</sup> Tr. at 466.

27 <sup>22</sup> Tr. at 508-9.

28 <sup>23</sup> Tr. at 509.

<sup>24</sup> Tr. at 508-9.

<sup>25</sup> Tr. at 769-770.

<sup>26</sup> Company's Initial Closing Brief at 39.



1 half way through the hearing. There are many variables between what other utilities may have or may  
2 not have included in their cost allocations, and it is not an appropriate comparison in this case at this  
3 time.

4 The Company's entire argument in support of its cost pool and its allocation ignores the  
5 ratemaking principles underlying recovery of expenses: were the expenses incurred reasonable and  
6 necessary for the provision of service to ratepayers? The Company has not adequately demonstrated  
7 that all of the costs in the pool are related to providing service to its ratepayers. Staff's  
8 recommendation strikes a balance between an appropriate allocation between the ratepayers and the  
9 shareholders and should be adopted.

## 10 VI. COST OF CAPITAL.

### 11 A. Staff Appropriately Utilized The Hamada Method To Adjust For The 12 Company's Lack of Debt In Its Capital Structure.

13 Staff has utilized the Hamada Adjustment appropriately in this case to account for the  
14 Company's lack of debt; in fact the Company adjusted its analysis and used the Hamada  
15 methodology in this case as well.<sup>27</sup> Here, the Company believes that Staff's Hamada Adjustment is  
16 overstated due to the beta used by Staff and Staff's use of book values instead of market values.  
17 Staff's appropriate use of book values, due to the regulatory nature of the analysis, was previously  
18 discussed in pre-filed testimony and Staff's Opening Brief. Mr. Bourassa believes that if the  
19 Company had its own beta, it would be higher than the sample companies, which would result in a  
20 much lower financial risk adjustment using the Hamada formula.<sup>28</sup> However, both of Mr. Bourassa's  
21 assertions are incorrect. First, he bases his statement that if the Company had its own beta, it would  
22 be higher, on the premise that the Company is smaller in size and would thus have company specific-  
23 risk.<sup>29</sup> However, the market does not reward unique risk (as it can be diversified away) and thus there  
24 is no basis to assume that the Company would have a higher beta.<sup>30</sup> Second, the assertion that a  
25 higher beta would result in a much lower financial risk adjustment using the Hamada formula  
26

27 <sup>27</sup> Ex. A-15 at 8-11 (Rebuttal Testimony of Bourassa).

28 <sup>28</sup> Ex. A-15 at 8 (Rebuttal Testimony of Bourassa).

<sup>29</sup> Ex. S-2 at 4 (Surrebuttal Testimony of Pedro Chaves).

<sup>30</sup> *Id.*

1 misrepresents the purpose of the adjustment. As Staff explained in its Opening Brief, the Hamada  
2 formula's purpose is to quantify differences in the cost of capital due to difference in capital  
3 structures, not to account for differences in beta.<sup>31</sup> Staff's use of the average beta of the sample  
4 companies should be adopted.

5 **VII. RATE DESIGN.**

6 **A. Staff Proposes A Reasonable And Sufficient Rate Structure.**

7 The difference between the Company and Staff concerning the percentage of revenue to be  
8 recovered from monthly minimums and the remainder percentage to be recovered from commodity  
9 charges are extremely small - less than two percent.<sup>32</sup> Staff's rate design does not create revenue  
10 shifting and was developed utilizing appropriate factors such as gradualism, promotion of efficient  
11 water usage and uniformity of rates among customer class.<sup>33</sup>

12 **B. A Hook-Up Fee Tariff Is Appropriate For The Company, However The**  
13 **Company's Proposed Language Concerning Treatment And Recording Of CIAC**  
14 **Should Not Be Included.**

15 Commission Staff supports a Hook-up Fee Tariff for the consolidated entity that will be Bella  
16 Vista. However, Staff recommends that the tariff not include the additional language requested by the  
17 Company concerning when fees collected are recorded as CIAC. Staff believes the standard language  
18 used in the tariff on that subject is sufficient and should be adopted as it is seen in Attachment B to  
19 the Surrebuttal Testimony of Marlin Scott.

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28 <sup>31</sup> *Id* and Staff's Opening Brief at 20.

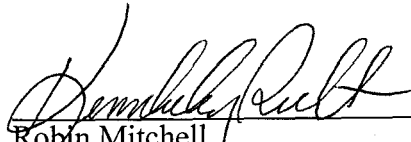
<sup>32</sup> Tr. at 746-47.

<sup>33</sup> Ex. S-8 at 36 (Surrebuttal Testimony of Crystal Brown).

1 **VIII. CONCLUSION.**

2 The Commission should adopt the Staff recommendations as discussed herein and in the  
3 Staff's Closing Brief as the rates produced thereby are just and reasonable and in the public interest.

4 RESPECTFULLY SUBMITTED this 29th day of October, 2010.

5  
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14 **29th day of October, 2010, with:**

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